Equity Financing

by Sophia

WHAT'S COVERED

Suppose you own a business and you need money for a long term project, but you don't really want to take out a loan. What are your options? This tutorial will cover the topic of equity financing. Our discussion breaks down as follows:

1. Reasons for Issuing Stock

Let's take a look at some reasons why a business may want to issue stock. Well, stock finances costs and growth for a business. Stock is an equity stake of ownership within the company.

Equity financing is a method of financing through the selling of a portion of ownership interest. Therefore, when a business issues stock, it's a form of equity financing; the business is issuing part of ownership in its company through the sale or issue of stock.

When a stock first enters the market, it enters through what is called an initial public offering, or IPO. It is the first time stock is offered to the public, and IPOs can be a great way to raise money. However, they are generally fairly expensive and quite time-consuming because, as you can imagine, there are a lot of regulations involved in putting them together.

Shareholders are the persons or organizations that buy the stock and then own that share of stock. Stockholders invest because they think they're going to see a potential gain, either through the raising of the stock price, so they can sell it for more later on, or possibly through dividend income.

With stocks, a **dividend** is the monies paid on a routine basis to shareholders from the profits of a company—for example, $0.25 per share. Capital gain of a stock is an earning based on the change of the price from the time of the stock to the time that you sell it.

> ↱ EXAMPLE If you buy a stock in a certain company at $5, and later sell it for $13, then you have a capital gain in that stock of $8. Market value is the current price of the stock on the open market. Therefore, market prices represent the price the stock is worth right now. That will help define what your capital gain is.

You may recall, from an earlier tutorial, there are two types of stock that can be issued by a company:

- *Common stock:* The most basic type of stock available for ownership within the company. Common stock owners are the last paid out, and they also have voting rights, but only on major issues within a company. They don't have the power to dictate every detail that goes on within the company. As mentioned, these common stock shareholders will be the last people to receive any dividends that the company pays out.

- *Preferred stock:* A much safer form of ownership, because this stock has priority in the dividend payment. Therefore, any time there's a dividend, the preferred stock stockholders receive that dividend before the common stock stockholders. It should be noted that preferred stock stockholders can also sometimes be forced to sell their stock back to the company, and they don't have voting rights, so they have no say at all in how the company is run.

TERMS TO KNOW

Equity Financing
A method of financing through the selling a portion of ownership interest.

Dividend
The monies paid on a routine basis to shareholders from the profits of a company.

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2. Retained Earnings

Retained earnings are the monies held from the net income, to be used by the corporation as opposed to dispersed to the shareholders. This is the part of the net income that the company or corporation holds back instead of distributing out to the different shareholders in the form of dividends.

Now, a higher retained earning means a lower dividend to the shareholders, and this may cause a decrease in the demand for the stock and also the price. A company that is reinvesting retained earnings is generally considered very attractive to investors. So, instead of simply holding that money back and keeping it in the bank account, if they are reinvesting those retained earnings back into the business to grow the business, this is generally considered to be a good deal for the shareholders.

TERM TO KNOW

Retained Earnings
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3. Earnings Per Share

Earnings per share is the financial value of each individual share of a common stock. To determine this number, you take the net income and divide that by the number of outstanding shares of stock.

EXAMPLE Suppose you have 1,000 shares of stock and your net income is $1,000. In this case, the earnings per share of stock in your company would be $1 per share—1,000 divided by $1,000.

The ratio is evidence of earning power of the company, and it can also indicate the potential for profit, seen in companies with a high earnings per share, or companies that have a growing earnings per share.

THINK ABOUT IT

Refer back to the earlier example of owning 1,000 shares and having a net income of $1,000. If, the next year, you have $1,200 in earnings, then $1,500 in earnings the year after that, and $1,600 in earnings the year after that, what do you think that indicates about company? Well, likely this indicates that the company is growing, and it has more earning power each year over year. Every time that earnings per share grows, it indicates the possibility of a profit. And when there's a profit, the company can pay a dividend to its shareholders like you.

BIG IDEA

The higher earnings per share, the bigger potential there is for a profit within the company.

TERM TO KNOW

Earnings Per Share
The financial value of each individual share of a common stock.

SUMMARY

Today we learned about the **reasons for issuing stock**, focusing on equity financing as a method of financing through the selling of a portion of ownership interest in a business. We also learned about **retained earnings** and **earnings per share**. What is the net income you have per share of stock?

Good luck!

Source: adapted from sophia instructor james howard

TERMS TO KNOW

Dividend
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Earnings Per Share
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Equity Financing
A method of financing through the selling a portion of ownership interest.

Retained Earnings
The monies held from net income to be used by the corporation as opposed to dispersed to shareholders.